

# RISING RATE STRATEGIES: CORE PLUS PORTFOLIO PERFORMANCE DURING TAPERING

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In an earlier discussion on preparing portfolios for [rising rates](#), we sought to illustrate the value of blending [rising rate strategies](#) to target a specific [yield](#) and [duration](#) profile in response to changes in [Federal Reserve \(Fed\)](#) policy. However, over the last 10 months, interest rates have actually fallen as the Fed has reduced the pace of its asset purchases. With ["tapering"](#) expected to be completed on October 29, we believe that this approach to risk management may be more relevant than ever as rates remain at depressed levels. In the remainder of this piece, we seek to highlight the total return profiles of these approaches since the start of the Fed's shift in policy. **Core Plus Performance During Tapering,**

Core Plus Strategy	Total Returns	Duration
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)	4.85%	4.88
Zero Core Plus Portfolio (80% Agg Zero, 20% HY Zero)	1.18%	0.00
Negative Core Plus Portfolio (80% Agg Neg, 20% HY Neg)	-5.52%	-5.40

  

Zero Duration Core Plus Strategy	Total Returns	Duration
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)	4.85%	4.88
Zero Core Plus Portfolio (80% Agg Zero, 20% HY Zero)	1.18%	0.00
80% Core Plus/ 20% Zero Core Plus	4.12%	3.91
70% Core Plus/ 30% Zero Core Plus	3.75%	3.42
60% Core Plus/ 40% Zero Core Plus	3.38%	2.93
50% Core Plus/ 50% Zero Core Plus	3.01%	2.44

  

Negative Duration Core Plus Strategy	Total Returns	Duration
Traditional Core Plus Portfolio (80% Agg, 20% High Yield)	4.85%	4.88
Negative Core Plus Portfolio (80% Agg Neg, 20% HY Neg)	-5.52%	-5.40
80% Core Plus/ 20% Negative Core Plus	2.78%	2.83
70% Core Plus/ 30% Negative Core Plus	1.74%	1.80
60% Core Plus/ 40% Negative Core Plus	0.70%	0.77
50% Core Plus/ 50% Negative Core Plus	-0.33%	-0.26

Traditional Core Plus portfolio proxied by an 80% allocation to the Barclays U.S. Aggregate Index and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained Index. Zero Core Plus portfolio proxied by an 80% allocation to the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index. Negative Core Plus portfolio proxied by an 80% allocation to the Barclays Rate Hedged U.S. Aggregate Bond Index, -5 Duration and a 20% allocation to the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Negative Seven Duration Index. Duration values listed as of 12/18/13. Sources: Barclays, BofA Merrill Lynch, WisdomTree, as of 10/22/14. Hypothetical illustration only. Past performance is not indicative of future results. You cannot invest directly in an index.

12/18/13–10/22/14

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definitions of indexes in the chart, please visit our [glossary](#). Over the last 10 months, nominal interest rates have fallen and [credit spreads](#) have generally [widened](#). With hindsight, we know that [hedging interest rate risk](#) cost investors performance. Additionally, even though high-yield bonds generated positive returns, risky debt underperformed [investment grade credit](#) by nearly 2%. However, we believe we can learn a great deal about portfolio construction from this experience: 1) For most bond investors, the greatest determinant of a portfolio's total return is the starting yield level. As shown in the table, over this period, the primary driver of returns was the amount of interest rate risk investors had in their portfolios. Unless investors believe that the risk of [deflation](#) is poised to increase, we continue to believe that hedging interest rate risk is a prudent course of action. 2) Although hedging over this period reduced total returns, a blended approach incorporating [zero duration](#) core plus strategies provided positive returns while reducing risk. In the case of the 50% Core Plus / 50% Zero Core Plus blend, an investor who reduced their interest rate risk by 50% underperformed by 1.84%. With rates at some of the lowest levels since mid-2013, we continue to believe that the risk of higher rates far outweighs the risk of lower rates. 3) [Negative duration strategies](#) and blends underperformed as long-term interest rates fell more than short-term rates. Given that credit spreads also widened over this period, a more opportunistic trade may be to increase exposure to negative duration, high-yield strategies as a way to address rate and credit spread normalization. While the ultimate evolution of the path of U.S. interest rates remains uncertain, we believe these new strategies for risk management give investors a [powerful tool kit](#) for refining their fixed income exposure. Even though rates have fallen over this period, the blended approaches shown above resulted in positive total returns for all but the most aggressive approach. In our view, the ability for investors to maintain traditional bond exposures while reducing interest rate risk can add value once rates begin to normalize.

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## **DEFINITIONS**

**Yield** : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

**Duration** : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Tapering** : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

**Credit spread** : The portion of a bond's yield that compensates investors for taking credit risk.

**Widen** : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

**Hedge** : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

**Interest rate risk** : The risk that an investment's value will decline due to an increase in interest rates.

**Investment grade** : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

**Deflation** : The opposite of inflation, characterized by falling price levels.

**Zero duration strategies** : Refer to WisdomTree's Interest Rate Strategies that target an overall portfolio duration of zero; namely, the WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund.

**Negative duration strategies** : Refer to WisdomTree's Interest Rate Strategies that target a negative overall duration; namely, the WisdomTree Barclays U.S. Aggregate Bond Negative Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Negative Duration Fund. .